UNITED STATES OF AMERICA Before the COMMODITY FUTURES TRADING COMMISSION

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LAKE SHORE ASSET MANAGEMENT LTD.

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NATIONAL FUTURES ASSOCIATION

CFTC Docket No. CRAA 07-02
ORDER DENYING STAY

On August 10, 2007, Lake Shore Asset Management, Ltd. ("Lake Shore") filed a petition to stay the effective date of a portion of a Notice of Second Amended Member Responsibility Action Under Compliance Rule 3-15 ("Second Amended MRA") issued by the National Futures Association ("NFA"). NFA opposes the petition. For the following reasons, we deny the stay.¹

BACKGROUND

On June 22, 2007, NFA issued a Notice of Member and Associate Responsibility Actions Under NFA Compliance Rule 3-15 ("Initial MRA"). On August 3, NFA issued an amended notice of MRA ("Amended MRA"); and on August 6, 2007, NFA issued the Second Amended MRA Notice.

In the Initial MRA, NFA noted a discrepancy between the \$1 billion Lake Shore claimed in promotional statements to have under management and the amounts that NFA found in customer accounts. NFA identified several statements in promotional material and on Lake Shore's website that, on their face, appeared to be misleading. For example, Lake Shore's

¹ The Commission issued an interlocutory order in this matter on August 13, 2007, in which it waived Commission Regulation 171.41(e), 17 C.F.R. § 171.41(e)—requiring the Commission to rule on MRAs in effect without awaiting a response from NFA—and directed NFA to file a response addressing the scope of its authority to take the action challenged by Lake Shore. Also on August 13, 2007, NFA, unaware of the Commission's order, filed a response in opposition to Lake Shore's stay petition ("Resp."). Upon receiving the Commission's order, NFA promptly gave notice that it would supplement its opposition in response to the Commission's order ("Not. Supp. Resp.," filed August 14, 2007). NFA filed its Supplemental Response ("Supp. Resp.") on August 17, 2007.

website represented that Lake Shore had returned huge profits to its investors during its 13-year history; contained hypothetical performance data without identifying it as hypothetical; and provided an inaccurate description of Lake Shore's registration.

NFA also alleged that Lake Shore represented to NFA auditors that it had no U.S. investors even though it did; and that it operated certain accounts that it was prohibited from operating without an exemption but had not applied to the Commission for an exemption. NFA alleged in addition that Lake Shore did not cooperate with auditors as required under its NFA membership agreement.

In the Amended MRA, NFA incorporated the allegations of the Initial MRA. By this time, NFA had identified and listed some of the accounts and names of funds that were associated in some way with Lake Shore. NFA also alleged that on further inquiry, it had reason to believe that more than three-quarters of the \$1 billion in assets that Lake Shore claimed to manage could not be accounted for. Amended MRA at 4-5; *see* Resp. at 1. The Amended MRA also stated that despite Lake Shore's claims of huge profits, contained in the promotional material it developed and distributed, the accounts that NFA was able to locate had incurred substantial losses.

In the Second Amended MRA, NFA alleged that examination of the records of monies held by futures commission merchants on behalf of Lake Shore showed the existence of numerous Lake Shore accounts and revealed multiple transfers of funds between and among the accounts. NFA also had located documentary evidence regarding the relationships between and among various Lake Shore entities and funds.

Lake Shore petitions for a stay of the following portion of the Second Amended MRA:

NFA Members receiving notice of this Second Amended MRA by service or otherwise who carry accounts in the name of, controlled by, or advised by

Lake Shore Ltd. including the accounts identified by Sentinel in Exhibit A or by any person or entity acting on behalf of Lake Shore Ltd. or any of its affiliates are prohibited from disbursing or transferring funds to Lake Shore Ltd. or any entity controlled by them for any reason without prior approval of NFA.

Pet. at 1. Lake Shore characterizes this action as an asset freeze. It asserts that NFA purportedly took this action pursuant to NFA's Compliance Rule 3-15, but that Rule 3-15 does not authorize asset freezes. Rule 3-15 states in relevant part:

A Member or Associate may be summarily suspended from membership, or association with a Member, may be required to restrict its operations (e.g., restrictions on accepting new accounts), or may otherwise be directed to take remedial action, (e.g., may be ordered to immediately infuse additional capital or to maintain its adjusted net capital at a level in excess of its current capital requirement), where the President, with the concurrence of the NFA Board of Directors or Executive Committee, has reason to believe that the summary action is necessary to protect the commodity futures markets, customers, or other Members or Associates.

Lake Shore first argues that Rule 3-15 limits NFA's choices of sanctions in MRAs to summary suspensions, restricting operations and requiring infusion of capital or maintenance of capital levels. It contends that Rule 3-15 does not authorize asset freezes "[n]or does it permit the NFA to restrict the activities of any person other than the . . . subject of the MRA." Pet. at 2. Second, Lake Shore contends that NFA's asset freeze is an unconstitutional taking of property without due process of law. Finally, Lake Shore contends that the funds that are the subject of the asset freeze are in accounts of persons other than Lake Shore—namely accounts that belong to and are controlled by foreign investment funds—and that Lake Shore has no control over those funds. Lake Shore argues that NFA wants to freeze these accounts indefinitely so that it can develop a case to prove that they are controlled by Lake Shore. Pet. at 3. Lake Shore argues that it is fundamentally unfair for NFA to seize property and hold it pending a hearing. It claims

that the asset freeze is causing irreparable harm to its business reputation and that of its representatives.

NFA opposes the stay, noting that Lake Shore has ignored the facts underlying the MRA that warrant restricting Lake Shore's use of funds. NFA argues that Lake Shore has broadly advertised a 13-year track record with an almost 20 percent annual return whereas all records made available to NFA show substantial losses. NFA states that from the limited information it has been able to obtain, it appears that Lake Shore lost \$29 million of customer funds, while reporting annualized returns for the years 2002 through 2006 of 20 to 50 percent. NFA states that \$750 million in customer funds are unaccounted for. NFA also asserts that when Lake Shore applied for membership, it represented that it was not subject to foreign secrecy laws. Nonetheless, Lake Shore now refuses NFA access to its records claiming that it is subject to such laws. It also has refused to answer NFA's questions. NFA states that it issued the MRA because it was unable to verify the nature of Lake Shore's business, the identities of its customers, the value of their investments, the amount and location of assets, and the accuracy of the performance representation featured on the website. NFA states that, whereas Lake Shore told the district court and the Commission that it was not involved with certain funds, it represented to its customers, in writing, that it managed these funds before the customers invested in them. See generally Resp. at 3-12 and Exhs. C-E thereto.

As to its authority to take the challenged action, NFA contends that Rule 3-15 is very broad and that Lake Shore relies on non-exclusive examples of NFA's authority in the rule to argue that the authority is limited. NFA stresses its "long history of including restrictions on the distribution of funds by and to Members pursuant to MRAs under appropriate circumstances."

Resp. at 14. It argues that Rule 3-15 allows a summary action if necessary to protect the futures

markets, customers, or other NFA members and associates. Supp. Resp. at 3. NFA asserts that it is necessary to restrict the distribution of funds because there is an immediate threat of customer financial loss. NFA notes that NFA compliance rules, specifically Rule 2-5, require all of its members to abide by the terms of an MRA, and that, even without the language of which Lake Shore complains, if a member were to move Lake Shore's funds without NFA approval the member may be considered an aider and abettor. Supp. Resp. at 6.

With regard to Lake Shore's due process arguments, NFA emphasizes that Lake Shore has not exercised its right to request a hearing and therefore its argument that the MRA is an unconstitutional taking of property cannot stand.

DISCUSSION

In reviewing petitions to stay the effectiveness of NFA member responsibility actions pending completion of further proceedings, Commission Regulation 171.41(d) requires the Commission to consider the following factors:

- (1) Whether, in the circumstances presented, the notice and opportunity for a hearing provided by the National Futures Association are consistent with principles of fundamental fairness; and
- (2) The likelihood that the denial of the petition would result in irreparable harm to petitioner; and
- (3) The effect a grant of the petition would have on the interests of the National Futures Association; and
- (4) The effect a grant or denial of the petition would have on the public interest.

17 CFR § 171.41(d). The burden of persuasion rests with the party seeking a stay. *Id.* at § 171.41(a). Before discussing the factors enumerated in Regulation 171.41(d), we address the petition's challenge to NFA's authority to issue the asset freeze.

A. NFA's Authority to Issue the Challenged Paragraph in the Second Amended MRA

NFA has authority to issue the challenged paragraph in the Second Amended MRA.

NFA Compliance Rule 3-15, quoted above in its entirety, specifically states that an NFA member may be directed to take remedial action. The Commission has held that the rule "authorizes NFA to fashion remedial measures suitable for a particular case and to deal with unforeseen circumstances as they arise." Commonwealth Financial Group, Inc. v. National Futures

Association, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,993 at 44,804 (CFTC Mar. 18, 1997). Accordingly, the rule need not specify all the remedial actions NFA may direct.

While Rule 3-15 may be directed at the member or associate who is the subject of the MRA, it is implicit in the rule that NFA may direct its members from disbursing or transferring funds to the subject of the MRA. Moreover, Rule 2-5, specifically requires all NFA members to comply with all orders of the NFA. Since an MRA is an order, and an asset freeze is part of that order, NFA members are required to comply with the MRA. If NFA may order a member not to disburse or transfer funds pursuant to the rule, it stands to reason that it may order other members not to disburse or transfer funds to the member in order to effectuate the restriction on the member itself. A contrary interpretation, such that NFA could only direct the member subject to the MRA not to disburse or transfer funds, would render the MRA ineffectual.

Moreover, it has been NFA's longstanding practice, without Commission objection, to restrict the distribution of funds by and to its members pursuant to MRAs, under appropriate circumstances. See, e.g., In the Matter of Glory Fund I, Inc. et al., NFA Case No. 96-MRA-006 (Nov. 15, 1996); In the Matter of Peter James Scott, et al., NFA Case No. 01-MRA-001 (August 6, 2001); In the Matter of Melrose Asset Management Corp., et al., NFA Case No. 02-MRA-002 (Sept. 3, 2002); and In the Matter of Longboat Global Funds, et al., NFA Case No. 04-MRA-

² The limitations on Rule 3-15 that Lake Shore advocates are, by their language ("e.g."), merely examples.

002. Indeed, as far back as 1986, NFA has imposed such restrictions, which the Commission has upheld. Weinberg v. National Futures Association, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,087 (CFTC June 6, 1986) (upholding an MRA that "prohibited NFA members from dispensing funds to [the member subject to the MRA] without NFA's approval.") Courts have held that an agency's interpretation of the statute it administers is due even more weight when its interpretation has been uniformly maintained for a considerable period of time. See Zenith Radio Corp. v. United States, 437 U.S. 443, 450 (1978). The Commission's longstanding concurrence in NFA's interpretation of its authority under Compliance Rule 3-15 is entitled to considerable weight.

B. Factors for Consideration in Regulation 171.41(d)

1. Fundamental Fairness

Under Regulation 171.41(d), the Commission reviews petitions for staying the effectiveness of an MRA, to determine, *inter alia*, "whether in the circumstances presented, the notice and opportunity for a hearing provided by the [NFA] are consistent with the principles of fundamental fairness." NFA's procedural rules contain due process protections, including the opportunity for a prompt post-deprivation hearing. The Commission oversees NFA. NFA decisions are subject to our review and ultimately to review in the courts of appeals.

Accordingly, we conclude that NFA's broad MRA authority, exercised subject to these protections, accords fundamental fairness to MRA subjects and adequately ensures against abuses.

Lake Shore received three opportunities to request a hearing. Each MRA notice stated that Lake Shore was "entitled to a prompt hearing on this matter before NFA's Hearing Committee if it so requests." Initial MRA at 7; Amended MRA at 8; Second Amended MRA at

6. Nowhere in its petition for stay did Lake Shore represent that it had requested a hearing. In its response, NFA stated that in spite of three offers of a hearing in less than three months, Lake Shore still has not requested one. Resp. at 17 and Not. Supp. Resp. at 1. NFA went as far as it could by offering a prompt post-deprivation hearing.

2. Irreparable Harm

In its petition, Lake Shore claims that the challenged paragraph in the Second Amended MRA is causing irreparable harm to its business reputation and that of its principals. Pet. at 3 and Ex. A, Amended Declaration of Philip Baker, at ¶ 14. Generally speaking, damage to reputation as a result of agency action "falls far short" of the type of irreparable injury necessary to obtain a stay. See In re Mayer, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,260 (CFTC Mar. 23, 1998); In re Reddy, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,272 (CFTC Mar. 9, 1998); Sampson v. Murray, 416 U.S. 61, 91-92 (1974).

Moreover, the NFA asset freeze initially was ordered on June 22, 2007. Not until August 10, 2007 did Lake Shore file its petition for a stay with the Commission, and despite three separate opportunities has not requested a hearing with NFA where it could seek to clear its name. Thus, even if reputational harm were considered to be irreparable injury, the petitioner's delay in seeking a stay and failure to request a hearing demonstrate that the petitioner itself did not consider the alleged harm to its reputation as a result of the asset freeze to be unduly burdensome. Accordingly, we find that the petitioner has failed to demonstrate irreparable harm.

3. Interests of the NFA

Lake Shore claims that a stay will promote the interests of NFA by preventing NFA from engaging in an unlawful and unconstitutional seizure of property. Petition at 3. However, as we determined above, NFA's conduct is neither unlawful as beyond its authority; nor, as we

determined earlier, is it unconstitutional. *See* Order of August 13, 2007 at 2, n.2. Granting Lake Shore's petition may impact adversely the interests of NFA by restricting its ability to protect the markets, and by hampering its ability to oversee its members.

4. Public Interest

Lake Shore claims that granting a stay will promote the public interest by requiring NFA to comply with its own rules and affording protection against deprivation of property without due process. Pet. at 4. NFA counters that granting the stay will affect adversely the public interest by "dissolving a prudent and measured approach by NFA to deal with the serious situation that has been created by Lake Shore Ltd." Resp. at 24. As outlined above, NFA has produced ample evidence to support a reasonable basis to believe that Lake Shore has engaged in misconduct and a strong inference that customer funds may be jeopardized without the asset freeze. The Commission is entrusted with ensuring fair practice and honest dealing in the futures markets, *Mayer*, ¶ 27,260 at 46,142, and the protection of customer assets is an important public interest consideration that the Act is designed to foster. *See* Sections 3 and 4d of the Act. Accordingly, we find that denying a stay of the challenged paragraph in the Second Amended MRA is in the public interest.

CONCLUSION

Lake Shore's petition for a partial stay of NFA's Second Amended MRA is denied.

IT IS SO ORDERED.

By the Commission (Acting Chairman LUKKEN and Commissioners DUNN, SOMMERS and CHILTON).

David A. Stawick

Secretary of the Commission

Commodity Futures Trading Commission

Dated: August 30, 2007

¹ Lake Shore contends that the funds subject to the asset freeze belong to and are controlled by others. Pet. at 3. We need not, and do not, reach the issue of whether Lake Shore is not the proper party to request a stay.